FYE 2016 Analyst Briefing Q&A

May 12, 2016
Fuji Heavy Industries Ltd.

Q ：Please tell us more about warranty claim expenses and how they have been reflected in your plan for fiscal year end March 2017.

A ：While warranty claim expenses for FYE2016 were quite high, we expect to see another ¥9.4 billion increase in FYE2017. Traditionally, we do not include recall expense forecasts in our plans. However, we have projected recall-related reserves of ¥30 billion in our next plan, given the significance of the Takata airbag issue and the guidelines that the National Highway Traffic Safety Association handed down recently.
We have forecast expenses likely to occur during FYE2017 in the U.S. related to the non-desiccated inflators subject to the recent NHTSA recall decision. We have added another amount for other regions as well, although this cost is difficult to estimate accurately at this time. In other words, while we have a general idea about recall expenses in the United States for FYE2017, we are not yet certain about other regions. Although there are still uncertainties involved, we plan for ¥420 billion in operating income, including recall expenses of ¥30 billion.

Q ：Are we to understand correctly that there will be no further expenses related to non-desiccated Takata inflators?

A ：While we have incorporated highly likely expenses for FYE2017, that does not necessarily mean that we have included all costs related to the non-desiccated Takata inflators. Of all Subaru vehicles using non-desiccated Takata inflators, there are still 3.6 million units worldwide that have not been subject to recall. In the worst case, all of these vehicles may become subject to an additional recall, the process of which may take several years. While we can identify the number of units to a certain extent, expenses vary region to region. This makes it difficult for us to come up with an accurate estimate. Through FYE2016, we have recorded ¥17 billion in recall reserves for 680,000 vehicles. Based on these unit costs, we added an equivalent amount of recall expenses for the remaining 3.6 million vehicles in our three-year plan from FYE2017 to 2019.

Q ：Can you tell us about your views of medium- and long-term sales in the United States? Under the new plan, you call for consolidated unit sales of 800,000 vehicles plus a certain amount in North America for FYE2021. This calculates out to between 1,300 and 1,400 unit sales per dealer at your present number of dealerships. Is this a correct understanding? Also, will you be able to grow sales without changing your current business model, which keeps per-vehicle incentives relatively low?

A ：We have 625 dealers at present. As I have said in the past, we have no particular plans to increase the number of dealers at this time. Our 2016 calendar-year sales plan for the United States is 615,000 vehicles, which works out to about 1,000 units per dealer. Increasing this amount to 1,200 units per dealer would allow us to reach 800,000 units–750,000 in the United States plus 50,000 in Canada. Our dealers in the United States tell us that they can capture 5% of the total 17 million-unit demand, which would be 850,000 vehicles. Given that our current share is 3.4%, this might be a bit bullish. However, it is definitely within the realm of possibilities for us to achieve 800,000 units by selling 750,000 in the U.S. and 50,000 in Canada.

Now, about incentives. Since we do not subscribe to the idea of raising incentives to increase unit sales, we are not considering increasing incentives. However, the recent trend for the industry as a whole is to increase incentives. Our per-vehicle incentive for FYE 2016 was $900. We forecast $1,000 per vehicle for the first half of FYE2017 and $1,200 for the second half ($1,100 average for the year). The best-case scenario, of course, is to not rely on incentives at all. However, we do expect that incentives will increase slightly over the medium term. Last month we saw very strong sales in the U.S. at 50,400 units, demonstrating continued momentum. We feel that Subaru has established a brand image that projects safety and peace of mind. We are improving our service structure and brand image to minimize any impact that a future economic downturn in the U.S. may have.

Q：I believe this year you have decided to apply a special extraordinary income to stock buybacks. Can you tell us more about returning profits to shareholders in ways other than dividends?

A：This year we received ¥48 billion temporary profit associated with a victorious lawsuit. Were we to distribute this to shareholders in the form of dividends, we would naturally have to report a decrease in dividends the following year. Our philosophy about returning profits to shareholders is to provide stable dividends (continuous and linked to business performance). Accordingly, we concluded that a stock buyback would be the most appropriate form of returning profits to shareholders. To be more specific, some suggested that only a portion of this temporary profit be used for this purpose, however, we clearly showed our intention to return profits by applying 100% to share buybacks, retiring the stock rather than holding on to it as treasury shares.

Next, I'll address our approach to future returns of profits. We won't categorically reject all share buybacks, and there is a chance we may do one in the future if we are presented with the same type of situation. However, our main choice of profit returns will always be in the form of dividends. We already have a policy on profit returns, which is to set a dividend payout ratio of between 20% and 40% on a consolidated basis. We want to maintain this policy moving forward as well. This year, we exceeded 30% ROE; we forecast an ROE down around 20% next year. Given this result, we may combine share buybacks as part of a flexible profit return policy, even though dividend payments will remain our major choice for returning profits to shareholders.

Q：At an exchange rate of ¥108, FYE2015 consolidated unit sales were 910,000 units generating ¥420 billion in operating income. You forecast ¥420 billion in operating income on 1.05 million unit sales for FYE2017 at an exchange rate of ¥105.

Even considering the slightly stronger yen, you call for essentially the same level of profits as FYE2015, despite selling 140,000 more units. Is it a case of higher expenses to increase capacity in North America this year, and we will see profits more in line with unit sales in following years (excluding the impact of exchange rates)?

A：This is a case where high profit ratios were associated with successful products that had relatively small R&D expenses and capital investment.

However, this structure is not one that is sustainable. As such, we are currently increasing investment in future growth (R&D, capital investment, depreciation expenses), while at the same time aiming to maintain the highest profit ratios in the industry. While profit ratios may be somewhat lower than they are currently, we are working to build a business that sustains persistent growth, rather than temporary profits.

Q：How does dealer profitability in the U.S. compare to other companies?

A：Profitability is very good for U.S.-based Subaru dealers. While we have made changes in dealership composition, the number of dealers overall has remained essentially unchanged at 625. In the past, Subaru dealers sold between 370 and 380 units on average. This year that figure will jump to nearly 1,000. This increase has been quite profitable for the dealers.

For Subaru to continue sustained growth, our customers must choose us again when they replace their current car. This is why we are asking dealers to invest their profits into improving their service structure. With this doubling or tripling of unit sales, dealers do not have enough service bays to fully serve their customers. This results in long wait times. We are keenly aware that improving our service structure is a pressing issue.

Q：Your plan also shows aerospace earnings falling by half compared to the prior year. What are the reasons for that?

A：During FYE2016, our Aerospace Company recorded ¥18.2 billion in operating income with a profit ratio of more than 10%. A present, however, private demand now accounts for a much larger portion of our business, between 70% and 75%. Most of this demand is business for Boeing, which is subject to foreign exchange sensitivity. Most of our private demand is building center wings for the 777 and 787. Profits are slightly lower for the newer types in the series. We will produce more of the new type products in FYE2017, resulting in a slight drop in profit due to the difference in sales composition. We are also dealing with initial development expenses that create a proportionately high cost burden until such time that the number of wings increases. We also have the depreciation associated with the completion of the plant building for 777X at Handa.

Accordingly, profit ratios for FYE2017 are lower than the prior year due to a combination of several reasons. These reasons include exchange rates, product composition for Boeing, and depreciation of our initial investments in the future of the 777X. In terms of defense demand, we started development of the UH-X during FYE2017. The costs here also have an impact on our bottom line.

Q：Tell us more about your plans to increase production capacity between FYE2017 and FYE 2019, as well as the relationship with capital investment.

A：With the conclusion of consignment production for the Camry in the U.S., we should free up two lines and 400,000 units. With some expertise in making slight gains, we believe it is possible to improve to 436,000 units. In Japan, we have room to make some production gains in our main plant. At our Yajima factory, we will finish upgrading paint facilities in

2018, which will resolve the bottleneck in our painting process and help increase the number of units we can produce. In other words, completing the planned paint factory upgrade and smaller improvements will increase our capacity in Japan.

Q ：At present, you have cash of approximately three months in sales. Please tell us more about your plans for cash over the medium term.

A ：As you say, we are aware that we are holding ample levels of cash.

As of the end of March 2016, we had ¥829.5 billion in cash and cash equivalents, with ¥170 billion in interest-bearing debt, leaving us with a net of ¥650 billion, or a little more than two months' worth of sales. However, we do not feel the need to make unnecessary investments just because we have two months' worth of sales on hand in cash. We discussed returning profits to shareholders earlier. As I mentioned, we plan to continue in line with our basic philosophy. At present, our capital policy calls for a high degree of balance between ROE and shareholders' equity to asset ratio. This is what we want to keep as our number one basis for making decisions on standards for coordinating cash levels and profit returns. While we ask your indulgence in accumulating cash when maintaining certain levels of ROE, we nonetheless have no intention of sacrificing ROE just to hold onto excess cash. Accordingly, we will continue to return profits to shareholders while keeping this equilibrium in mind.